Markets surge into the New Year

Gloomy outlook persists

January 20, 2012 – The New Year of the Chinese Water Dragon comes around every 60 years, and is seen as especially auspicious in the Chinese horoscope. It begins on Jan. 23 by the Gregorian calendar reckoning. This particular sign is said to bring more than a dollop of good fortune. That, at least, is a self-fulfilling prophecy, as Hong Kong's Hang Seng Stock Index has surged 8% since the beginning of the year. Not bad, considering many of the world's other big indexes have climbed between 4% and 6% in the same period. Is it the start of a trend?

The Bank of Canada doesn't see a lot of room for optimism. In a statement accompanying its interest rate decision last Tuesday, the BoC observed that with the European debt crisis, uncertainty has increased, financial markets have tightened, and risk aversion has risen. With December's headline inflation at an annual 2.3%, and core inflation at 1.9%, both down from November, the Bank left its target overnight lending rate unchanged at 1%. The BoC said, "Prolonged uncertainty about the global economic and financial environment is likely to dampen the rate of growth of business development." And markets are, if nothing else, all about the rate of growth of business development.

In its Monetary Policy Report, the Bank added that it expects a lengthy recession in Europe, which is likely to weigh on commodity prices, with the exception, perhaps, of energy prices. "The prices of non-energy commodities are projected to fall in 2012 in reaction to diminished prospects for global economic growth," it said.

With non-energy commodities comprising over 50% of Canada's trade exports, the outlook seems pretty grim, and by extension pretty grim for the Canadian stock market, which is heavily weighted to resource issues. Energy, of course, is a different story, and oil prices are generally expected to hold up, despite recent forecasts of near-term softening demand, a result mostly of a milder North American winter, recently elevated prices, a prolonged recession in the eurozone, and weaker economic growth globally.

Although fourth-quarter economic conditions in both Canada and the US appear far better than in Europe, the outlook for the first half of the year is dimming. According to Statistics Canada, factory sales climbed 2% in November, the fourth increase in five months. The Bank of Canada raised its forecast for fourth-quarter GDP to an annualized 2%. But this rate of growth is expected to fade as the global slowdown takes hold in the first half of the year, and both domestic demand and export growth weaken.

In the US, the December consumer price index fell remained unchanged month over month, but fell to 3.0% year over year, from 3.4% in November, taking some of the pressure off of the beleaguered US consumer. In addition, new weekly claims for jobless benefits tumbled again, to a four-year low.

Still, slipping fourth-quarter earnings reports are raising fears that the winter rally may be about to lose some steam. Estimates of earnings growth for US stocks have been revised down for 2012, as profit warnings mount. And the Dow Jones Transportation Average has been dropping while the Dow Jones Industrial Average has been rising, a phenomenon that's often seen as an early bearish indicator, as cyclical transportation companies are usually the first to feel the effects of a broader economic slowdown. The Baltic Dry Index, another, though more volatile, gauge of shipping demand, has also been dropping steadily since December.

Over in the eurozone, the clock is ticking towards some sort of dénouement in the Greek sovereign debt crisis, as the government and creditors worked last week towards a swap deal that would see private creditors, mostly European banks and insurance companies, take a haircut of at least 50% on their holdings of Greek debt. Such an agreement is a condition of further bailout funds from the European Union. The International Monetary Fund, meanwhile, ramped up its efforts to globally socialize European fiscal problems by warning that it needs another $500 billion of funding to beef up its emergency lending resources. The US, UK, Canada, and others have so far resisted repeated calls from the IMF to increase the size of their contributions. Yet the drumbeat continues.

Against this rather gloomy backdrop then, it came as something of a surprise to see the main stock benchmarks advance for another week.

Canada's stock market, the TSX, now ranks fourth-largest in the world in terms of market capitalization, and is attracting growing foreign investment flows, as the TSX and TSX Venture Exchanges grow in reputation for listings, liquidity, and transparency. Last week, the S&P/TSX Composite Index, which tracks 253 of the exchanges largest issuers, advanced 1.4% on the week for a 3.7% gain in the first three weeks of the year.

Likewise, the Dow Jones Industrial Average gained 2.4% week-over-week, for a 4.1% year-to-date advance. And the S&P 500 Composite Index climbed 2.0% on the week, for a 4.6% gain so far in 2012.

Is the January stock rally the start of a trend? The background suggests that it is not, and that we'd better prepare for an about-face soon. Still, we enter the Chinese year of the Water Dragon with robust market gains. And while Water is said to curb some of the Dragon's wilder enthusiasms, it is still subject to volatile swings and great changes. Investors be warned!■

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